No. 296

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

PANHANDLE EASTERN PIPE LINE COMPANY, ILLINOIS NATURAL GAS COMPANY, AND MICHIGAN GAS TRANSMISSION CORPORATION, PETITIONERS

v.

FEDERAL POWER COMMISSION, CITY OF DETROIT, COUNTY OF WAYNE, MICH., MICHIGAN CONSOLIDATED GAS COMPANY, AND MICHIGAN PUBLIC SERVICE COMMISSION, RESPONDENTS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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INDEX

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Panhandle Eastern Pipe Line Company, a Delaware corporation (herein referred to as "Panhandle Eastern"), Illinois Natural Gas Company, an Illinois corporation (herein referred to as "Illinois Natural"), and Michigan Gas Transmission Corporation, a Delaware corporation (herein referred to as "Michigan Gas"), pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above cause on June 6, 1944.

OPINIONS BELOW

The opinion of the court below (R. 7198) and the dissent thereto (R. 7218) filed June 6, 1944, are not yet officially reported. The opinion of the Federal Power Commission was entered September 23, 1942 (R. 14).

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 6, 1944 (R. 7219). Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, and section 19 (b) of the Natural Gas Act.

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act, approved June 21, 1938 (52 Stat. 821; 15 U. S. C. 717), are set forth in the Appendix hereto (pp. 29-31).

QUESTIONS PRESENTED

(1) Whether the refusal of the Commission to receive evidence of reproduction or replacement cost and evidence of the value of petitioners' producing properties amounted to a denial of due process.

(2) Whether limiting the sale price of petitioners' gas for resale so as to provide an over-all return of 6½ per cent on the depreciated cost of petitioners' properties including those devoted to production and gathering of natural gas and excluding petitioners' tendered evidence as to the market value of petitioners' gas leaseholds constituted an exercise of jurisdiction over production and gathering of natural gas in violation of the Natural Gas Act.

(3) Whether the Commission's action in treating petitioners' business as an entirety and refusing to make any allocation or separation with respect to petitioners' regulated and unregulated sales was beyond its statutory power.

(4) Whether the return allowed by the Commission and affirmed by the court below is just and reasonable under the tests and standards established by this Court.

STATEMENT

On February 28, 1941, the City of Detroit and the County of Wayne, Michigan, filed a complaint before the Commission against petitioners, alleging that petitioners' rates and charges for natural gas sold to Michigan Consolidated Gas Company for resale in that City and County were unreasonable, unjust, and unduly discriminatory (R. 7002). The Commission, on its own motion, instituted an investigation of all wholesale natural gas rates and charges of petitioners (R. 7061). These proceedings were consolidated (R. 7064). After a lengthy hearing before the Commission's trial examiner, the Commission on September 23, 1942, entered its order upon such consolidated docket requiring petitioners to file new schedules of rates and charges for, or in connection with, their transportation and sale of natural gas in interstate commerce for resale for ultimate public consumption, so as to reflect, when applied to their 1941 transportation and sales, a reduction of not less than $5,094,384 per annum below their 1941 consolidated gross operating revenues of $17,789,573 (R. 38, 42). On October 30, 1942, petitioners' motion for rehearing and reconsideration, seasonably filed (R. 7141), was denied (R. 7150).

Thereupon, petitioners promptly filed in the United States Circuit Court of Appeals for the Eighth Circuit (in whose jurisdiction petitioners had their principal place of business) their petition for review of said order of the Commission (R. 1). On June 6, 1944, that court rendered the judgment review of which is sought here, affirming the order of the Commission (R. 7219).

The properties of petitioners, now owned by Panhandle Eastern[1], constitute a natural gas production, transportation and marketing system. The system produces and purchases gas from the Panhandle Field in Texas and from the Hugoton Field in Kansas, Oklahoma, and Texas. It extends from the Panhandle Field and the Hugoton Field through the states of Oklahoma, Kansas, Missouri, Illinois, Indiana, Ohio, and Michigan, with termini in Indiana, Ohio and Michigan. When the proceedings before the Commission were commenced, Michigan Gas, a wholly owned subsidiary of Columbia Gas and Electric Corporation, owned that portion of the then existing transmission system extending eastward from Dana, Indiana. Michigan Gas purchased its entire supply of natural gas from Panhandle Eastern and sold such gas to various distributing companies for resale. It also transported for the account of Panhandle Eastern gas sold by Panhandle Eastern directly to various distributing companies serving communities in Ohio and Michigan. Illinois Natural, a wholly owned subsidiary of Panhandle Eastern, owned the lateral lines in the State of Illinois extending from Panhandle Eastern's main line and purchased its entire supply of gas from Panhandle Eastern and sold such gas to distributing companies and industrial companies in Illinois (R. 17-18).

Most of the gas is sold to distributing companies for resale, but a very substantial quantity is sold direct to industrial customers. For the year 1941 direct sales represented 13.2% of all gas transported and sold. The revenue derived therefrom amounted to $1,500,527 (R. 5947, Ex. 251, L. 23, Col. F.).

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[1] Panhandle Eastern purchased Michigan Gas February 6, 1942, and dissolved it March 31, 1943, after acquiring all of its properties. Illinois Natural, a wholly owned subsidiary of Panhandle Eastern, was dissolved March 31, 1943, after the latter acquired all of its properties.

At the hearing, petitioners caused to be identified and offered in evidence certain exhibits, and testimony relating thereto, which would have shown the present replacement or reproduction cost of their physical properties as of June 30, 1941, less observed depreciation, and the market value of petitioners' gas leaseholds. The Commission's trial examiner sustained a motion to strike and exclude the exhibits above referred to and all testimony in support thereof (R. 715-718; R. 3973-3975). At the time the evidence was tendered, counsel for petitioners made it clear that it was offered as being relevant not only to a determination of what rate base should be used and what rate of return should be applied but also to a determination of the present value of petitioners' property and to a determination of the return in dollars which they are justly and equitably entitled to receive (R. 715).

The evidence excluded would have shown that the reconstruction cost of the fixed physical properties of Panhandle Eastern, less observed depreciation, was $61,807,269[2] while the book cost of such properties less reserves for depreciation was $53,915,095[3], a difference of $7,892,174.

The excluded evidence would have shown that the present value of the physical properties of Michigan Gas, determined by deducting the observed depreciation from the

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[2] The value of "fixed properties," $70,502,792, shown in excluded Exhibit 62, Col. D., L. 33,—R. 4347, included $8,695,524 as the market value of leases. Subtracting the latter item leaves $61,807,268 as the value of physical properties, determined by deducting the amount of observed depreciation from reproduction cost.

[3] The "gas plant classified" on that date stood at $64,622,148, and the "construction work in progress" at $383,556—a total of $65,005,704. This, however, included cost of leaseholds in the aggregate sum of $1,745,206, leaving $63,260,498 as the cost of physical properties (Exhibit 52—R. 4275-4277). On that date, depreciation reserves for physical properties amounted to $9,345,403 (Exhibit 48—R. 4261). The difference, $53,915,095, represents the book cost of physical properties, less reserves therefor.

trended original cost of June 30, 1941, was $13,810,092 (Ex. 84, R. 4851), while the "book cost" of such properties, less the reserves for depreciation, amounted to $10,876,284[4], a difference of $2,933,808.

The excluded evidence would have shown that the present value of Panhandle Eastern's leaseholds, as reflected in their market value, is $8,339,722 (Ex. 39, R. 4199, 4201, 492), while the book cost of such leaseholds, less reserves for depletion, amounted to $955,096 on that date[5], a difference of $7,384,626.

Thus, had this rejected evidence been received and considered and, upon consideration, been held to reflect the present value of petitioners' properties, the present value of such properties as of June 30, 1941, would have been found to be $18,210,608 in excess of the book cost of those properties less book accruals for depreciation and depletion.

Petitioners further offered an exhibit (R. 4726) showing a valuation made in 1937 of Panhandle Eastern's leaseholds and an exhibit (R. 4719) showing a valuation made in 1938 of Panhandle Eastern's physical properties. This valuation showed a total value of $63,248,549 (R. 4723), approximately $7,300,000 in excess of book cost less accruals for depreciation and depletion as of that date (Ex. 48, R. 4259, 4261). These exhibits and all evidence explanatory thereof were also excluded by the examiner. They would have shown a valuation of Panhandle Eastern's property at the time the Natural Gas Act became effective.

[4] The book cost was $12,402,884, and the depreciation reserve was $1,526,600 (Ex. 88, R. 4863-4864).

[5] Cost of leaseholds was $1,745,206 (Exhibit 52, p. 1, LL. 10 and 12—R. 4275), and reserves for depletion, etc. aggregated $790,110 (Exhibit 48, p. 2, LL. 10 and 33—R. 4261). These leaseholds were acquired through foresight and good judgment at low prices prior to a determination of the limits of the field and principally over a period from 1930 to 1932.

The Commission approved the trial examiner's action in striking all evidence of reproduction cost and value of leaseholds, both as of the time of enactment of the Natural Gas Act and as of the time of the hearing, basing its ruling upon its construction of the Natural Gas Act.[6]

Petitioners presented at the hearing a suggested basis for allocating earnings and cost of service between regulated and unregulated sales (R. 5947, Ex. 251; R. 3631-3676, 3857). The Commission's staff also presented a suggested allocation (R. 6883-6887, Ex. 263; R. 3994-4002). The Commission refused, however, to make any allocation, and treated petitioners' business as one subject to regulation in its entirety, saying (R. 34),

> We conclude, therefore, that, under such circumstances, it is not unreasonable to treat the entire business as a unit requiring no allocation as between the two classes of sales.

Panhandle Eastern commenced doing business as a going concern in 1932 with a capital structure of $49,278,869 (Ex. 48, p. 2, R. 4261). As of March 31, 1942, the invested capital of the system had been increased to $77,703,364, represented by (Ex. 267, R. 6993A)

Long term debt	$33,254,500
Preferred stock	16,000,000
Common stock and surplus	28,448,864
Total	$77,703,364

[6] The Commission in its opinion stated: "We held in the *Chicago District Electric Generating* case that under section 208(a) of the Federal Power Act (the provisions of which are identical with Sec. 6(a), supra) that reproduction cost evidence is inherently fallacious and should be disregarded under that statute." (R. 19). It may be observed that the Commission's opinion in the cited case, 39 P.U.R. (N.S.) 263, has never been reviewed by any Court.

In view of the Commission's criticism of certain capital items amounting to $1,153,874 petitioners herein eliminate those items and treat their unquestioned invested capital as of March 31, 1942, as being $76,549,490, and their common stock and surplus as being $27,294,990.

Petitioners are operating companies wholly dependent upon their own credit and resources in obtaining capital for growth and expansion (Ex. 147, R. 5107). Petitioners own no distribution companies, nor have they affiliations with the owners of any such companies.

Their equity capital comprises only approximately 35% of the corporate structure. The other securities, preferred stock and long term debt, have favorable interest rates (having been issued during the recent period of low service costs on debt capital), but contain burdensome sinking fund requirements, thus increasing the risk of the equity capital and restricting the payment of dividends to the equity stockholders (R. 6075, 6994). Panhandle Eastern paid no dividend on its equity capital until 1937 (Ex. 174, R. 5449).

Petitioners' evidence showed that they required a minimum return of $5,172,129 to provide adequate service costs on their capital structure, as follows:[7]

Cost of servicing long term debt	$ 957,730
Cost of servicing preferred stock	939,000
Cost of servicing common stock and surplus	3,275,399
Total	$5,172,129

The Commission found the reasonable cost of servicing the long term debt and preferred stock to be as stated above, but made no finding as to cost of servicing the equity

[7] These figures are derived from Ex. 267, R. 6993-A and Ex. 253, R. 6097, after deducting the items of invested capital aggregating $1,153,874 questioned by the Commission.

capital (R. 29). It did not fix the return allowed from a consideration of cost of service, but found that a "fair and liberal" return would be 6½% on the "rate base" selected by it (R. 30). This rate base was $67,137,305, which the Commission determined to be the actual legitimate cost of the plant in service (including leaseholds) at December 31, 1941, less accrued depreciation plus working capital of $920,000. It did not include petitioners' properties in the course of construction at December 31, 1941, which were completed and in service at March 31, 1942, before the hearing was closed, nor did it include any allowance for construction work in progress at the close of the hearing. The resulting return allowed was only $4,363,925 (R. 30), $808,204 less than petitioners' cost of servicing their unquestioned invested capital.

On review the court below, with one judge dissenting, affirmed the Commission's order on the following grounds: (1) The ruling of the trial examiner in excluding all evidence of the reproduction or replacement cost of Panhandle Eastern's properties and the market value of Panhandle Eastern's leaseholds was not a denial of due process. The court on this point stated that the action of the trial examiner presents a question not free from doubt, as the precise issue has not heretofore been decided; (2) The Commission had not erroneously assumed jurisdiction over petitioners' production and gathering of natural gas; (3) The Commission's failure to make an allocation or segregation of revenues derived from direct sales of gas to customers for their own use did not make its order invalid, and (4) The return allowed by the Commission was not shown to be unjust, unreasonable or confiscatory.

REASONS FOR GRANTING THE WRIT

1. *The question involved in the rejection by the Commission of the tendered evidence is of great public importance.*

The question of whether the lower court was right in upholding the Commission's exclusion of petitioner's evidence involves a constitutional issue of due process of broad and grave public interest. It is not a mere question of construing Section 6(a) of the Natural Gas Act, as the Commission visualized the issue, nor is it one of searching, as did the court below, for "teachings and implications" from decisions of this Court in cases wherein the issue was not involved.

In the case at bar the Commission at the threshold of its consideration excluded all evidence of reproduction cost and market value. The Commission in advance selected one formula for determining a rate base, barring all others and evidence germane thereto.

The question involved is what are the minimal requirements, as a matter of constitutional right, of a fair and full hearing before an administrative Commission with quasi-judicial authority.

Heretofore, courts have recognized that regulatory commissions are frequently manned by lay members less trained in a careful discrimination and appraisal of evidence as offered than the regularly constituted courts. These commissions have been consistently required as a minimal requirement of due process to afford parties in interest a full and complete hearing, to permit, within reasonable bounds, each party to present the full facts as he visualizes the issues involved. This course safeguards the interests concerned, restrains the regulatory commissions from arbitrary action based upon inadequate information and affords the reviewing court a sufficient presentation of all the facts to enable it to pass intelligently upon the resulting ruling both from the point of view of the public interest and the constitutional rights of the regulated enterprise or body.

This Court has many times placed its approval upon several criteria as *proper for consideration* for rate making purposes. This Court has held that the Commission is not bound in its final determination to adopt any one or any combination of approved formulas. Notwithstanding this background of the law the Commission in the instant case selected in advance of its consideration of the case one of the several such approved formulas and, receiving evidence consonant with it, rejected all other evidence offered by petitioners although having probative value in relation to other proper criteria.

The Commission did this on the theory that Section 6(a) of the Natural Gas Act amply supported it in so doing.

The court below disagreed with the Commission's interpretation of Section 6(a), saying:

> There is little to indicate that Congress in enacting § 6(a) intended to change the law of evidence. That section * * * probably has no controlling effect upon the admissibility of evidence at a rate hearing.

The court below, however, reached, in effect, the same result as the Commission and, in so doing, said:

> Unless we have misconceived the teachings and implications of the opinion of the Supreme Court in the Hope Natural Gas Company cases, the standards by which the validity of the Commission's order is to be judged require its affirmance.

The holding of the court below is not based upon any rule of statutory construction; it is prompted by that court's acceptance of a new and delimited concept of the "minimal requirements" of due process for a full and fair hearing.

The question involved is of great and far reaching public interest. It affects, or is likely to affect, procedure before

the increasing number of Federal regulatory bodies and commissions. The lower court's decision, being rested upon "teachings and implications" of opinions of this Court, if permitted to stand, would likewise have a far reaching effect as a precedent, though not binding, upon innumerable regulatory and rate making bodies of the several states. The judicial interpretation of the requirements of due process under the Constitution of the United States has consistently influenced the interpretation of like protective clauses in the constitutions of the various states.

No issue could more definitely be affected with a public interest than the question involved in the rejection by the Commission, affirmed by the court below, of the evidence tendered by petitioners.

2. *The question of whether the Commission may refuse to receive and consider in a rate hearing evidence of the character offered has never been decided by this Court.*

The precise question of whether the Commission may refuse to admit and consider evidence of the type offered by petitioners has never been decided by this Court. In a long line of decisions this Court has indicated that the rejection of evidence of probative value is violative of due process. *Morgan* v. *U. S.*, 298 U. S. 468; *Ohio Bell Telephone Company* v. *Public Utilities Comm.*, 301 U. S. 292; *Interstate Commerce Commission* v. *L. & N. R. R. Company*, 227 U. S. 88; *Los Angeles Gas & Electric Corp.* v. *R. R. Commission*, 289 U. S. 287; *Driscoll* v. *Edison Light & Power Co.*, 307 *U. S.* 104; *Bluefield Waterworks and Improvement Company* v. *Public Service Commission*, 262 U. S. 679. The Commission's affirmance of the trial examiner's action was based upon its construction of section 6(a) of the Natural Gas Act and upon a dictum in

the concurring opinion in *Federal Power Commission* v. *Natural Gas Pipe Line Company*, 315 U. S. 575, 606. No support is to be found for the Commission's position in any opinion of this Court. The court below stated (R. 7205):

> Apparently no court has as yet ruled that the Federal Power Commission may, in a rate hearing, refuse to receive and consider evidence of replacement or reproduction cost of the properties of a company subject to the Natural Gas Act. It was held, in effect, in the case of Federal Power Commission v. Natural Gas Pipe Line Co., 315 U. S. 575, 586, 606-607, and in the Hope Natural Gas Company cases, 320 U. S. 591, 602-605, that the Commission was not bound to give weight to such evidence in determining rates.
>
> Nevertheless, the question whether the refusal of the Commission to receive the evidence of reproduction or replacement cost or value offered by the petitioners amounted to a denial of due process is *not free from doubt*. (Italics ours.)

In the *Natural Gas Pipe Line* case, *supra*, the Commission, for the purpose of issuing an interim order, accepted the company's statement that the book cost of the property existing at the end of 1938 was $60,172,843, including working capital of $975,000. It also accepted the company's estimate that the value of all physical property calculated at reproduction cost new was $74,420,424. Evidence of reproduction cost was not only admitted but the Commission used it as the rate base. Clearly, the question presented here was not before this Court in that case. This Court stated at page 586:

> The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjust-

ments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been over-stepped.

The Court did not state that the Commission might adopt at the outset a single formula and exclude all evidence not consistent with such formula; nor is such a view implicit in the Chief Justice's statement. If the Commission is free to exclude all evidence despite its probative value except evidence going to the question of original cost, then there is little room, indeed, within which it is called upon to make pragmatic adjustments based upon the peculiar facts of any rate case.

The Chief Justice stated at pages 585-586:

> By long standing usage in the field of rate regulation, the "lowest reasonable rate" is one which is not confiscatory in the constitutional sense. * * * Assuming that there is a zone of reasonableness within which the Commission is free to fix a rate varying in amount and higher than a confiscatory rate, * * * the Commission is also free under section 5(a) to decrease any rate which is not the "lowest reasonable rate."

There can be no doubt as to the Commission's wide discretion in the matter of fixing rates, but, clearly, the Commission, on the basis of the above statement, has authority to fix rates above the "lowest reasonable rate." This being true, the petitioners should have been given a full and fair hearing in order that they might produce evidence of probative value which might persuade the Commission to fix a rate higher than the lowest reasonable rate. The action of the Commission in the instant case amounts to a disregard of the oft repeated statement in the cases that rate-making

is a process of selection from all available data. It is in effect to prejudge a case before its hearing.

If Congress had intended that the Commission should adopt a single formula, it would have said so. Congress did not intend by section 6(a) to free the Commission from hearing evidence of fair value.

In the concurring opinion in the *Natural Gas Pipe Line* case, *supra*, it was stated at page 606:

> As we read the opinion of the Court, the Commission is now freed from the compulsion of admitting evidence on reproduction cost or of giving any weight to that element of "fair value." The Commission may now adopt, if it chooses, prudent investment as a rate base—the base long advocated by Mr. Justice Brandeis. And for the reasons stated by Mr. Justice Brandeis in the *Southwestern Bell Telephone* case there could be no constitutional objection if the Commission adhered to that formula and rejected all others.

Mr. Justice Jackson in his dissent in *Federal Power Commission et al* v. *Hope Natural Gas Company*, 320 U. S. 591, in reference to the above quoted statement, said, at page 628:

> The Minority opinion I understood to advocate the "prudent investment" theory as a sufficient guide in a natural gas case. The view was expressed in the court below that since this opinion was not expressly controverted it must have been approved. I disclaim this imputed approval with some particularity, because I attach importance at the very beginning of federal regulation of the natural gas industry to approaching it as the performance of economic functions, not as the performance of legalistic rituals.

This Court, in affirming the Commission in the *Hope* case, *supra*, and reversing the Circuit Court, did not lay down the rule that the Commission could reject all evidence ex-

cept that which might go to the determination of original cost. As noted, the Commission in that case admitted and considered evidence of reproduction cost and, thus, the question here presented was not before this Court.

Mr. Justice Reed dissenting on another ground stated, page 623:

> I agree with the Court in not imposing a rule of prudent investment alone in determining the rate base. This leaves the Commission free, as I understand it, to use any available evidence for its finding of fair value, including both prudent investment and the cost of installing at the present time an efficient system for furnishing the needed utility service.
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> • • • • •
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> The Federal Power Commission did not, as I construe their action, disregard its statutory duty. They heard the evidence relating to historical and reproduction cost and to the reasonable rate of return, and they appraised its weight. The evidence of reproduction cost was rejected as unpersuasive, but from the other evidence they found a rate base which is to me a determination of fair value. On that base the earnings allowed seemed fair and reasonable.

It is thus apparent that Mr. Justice Reed was of the opinion that the Commission in the *Hope* case had performed its satutory duty in permitting the introduction of evidence tending to show reproduction cost or present value.

The court below, in affirming the action of the Commission, stressed what it considered implications of this Court's opinion in *Pittsburgh Plate Glass Company v. National Labor Relations Board*, 313 U. S. 146. The issue in that case was not, however, the same as that in the case at bar. The point upon which this Court divided in the *Pittsburgh Plate Glass Company* case was not as to whether due process required the National Labor Relations Board to hear

evidence pertinent to a determination of the criteria to be adopted in selecting the appropriate bargaining unit. The point was whether the National Labor Relations Board had heard and considered evidence as to the appropriate unit and made a determination of the issue in a former proceeding which was binding upon all the parties to the subsequent proceedings. The *Pittsburgh Plate Glass Company* case is not authority for the Commission's action in the case at bar. Here, there had been no prior hearing but the Commission was in the initial stage of its rate-making process as applied to petitioners. The Commission, in order properly to exercise its wide discretion, was bound to admit petitioners' evidence regardless of the weight ultimately given to it.

It may be observed that Mr. Justice Reed, who wrote the opinion for the Court in the *Pittsburgh Plate Glass Company* case, recognized in his dissent in the *Hope* case that the Commission was required to hear evidence of reproduction cost or present value. It may also be noted that the present Chief Justice, with the then Chief Justice and Mr. Justice Roberts concurring, wrote a vigorous dissent in the *Pittsburgh Plate Glass Company* case, stating at page 177:

> One of the most important safeguards of the rights of litigants and the minimal constitutional requirement, in proceedings before an administrative agency vested with discretion, is that it cannot rightly exclude from consideration facts and circumstances relevant to its inquiry which upon due consideration may be of persuasive weight in the exercise of its discretion.

From the foregoing discussion, it is clear that the issue involved in the case at bar has never been decided by this Court. The public importance of the question warrants a final determination thereof.

3. *The decision of the court below is in conflict with a decision of the U. S. Circuit Court of Appeals for the Tenth Circuit.*

In the instant case the Commission treated petitioners' business as an entirety without making an allocation between property, capital and revenue related to direct sales and sales for resale. The Commission considered such an allocation or segregation unnecesary. It may be observed, however, that the revenue derived from direct sales constituted a substantial portion of petitioners' business. In 1941 direct sales represented 13.2% of all gas transported and sold. The revenue derived therefrom amounted to $1,500,527 (R. 5947).

Section 1(b) of the Natural Gas Act provides:

> The provisions of this Act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, *but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.* (Italics supplied.)

Judge Riddick, dissenting below, stated (R. 7218):

> Heretofore, the Commission has recognized the necessity of such an allocation and has made it. Re *Interstate Natural Gas Co., Inc.*, 48 PUR (NS) 267, 279; Re *Canadian River Gas Co.*, et al, 43 PUR (NS) 205, 231; Re *Cities Service Gas Co.*, 50 PUR (NS) 65, 89. That a separation of transactions within and beyond the jurisdiction of the Commission is required by the Natural Gas Act, and must be made in order that "regulation may be confined to its permitted field" is

held in *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 10 Cir., decided May 16, 1944. Here the Commission has admittedly refused to observe the limit upon its jurisdiction, fixed by Congress. In this situation it seems to me idle to inquire whether the Commission's order, call it a "pragmatic adjustment" or what-not, does or does not result in confiscation of petitioners' property, or whether it is less or more favorable to petitioners than would have been the case had the Commission confined itself to its permitted field. It is enough to require a remand of this proceeding that the Commission has exceeded the statutory limitation on its powers.

In *Colorado Interstate Gas Co., et al.* v. *Federal Power Commission, et al.*, decided by the Circuit Court of Appeals for the Tenth Circuit May 16, 1944, cited by Judge Riddick, (not yet reported) the question of whether the Commission had made a proper allocation arose and the Court stated:

> Where, as here, a natural gas company is engaged in an integrated business, part of which is subject to regulation and part of which lies beyond the reach of the regulatory jurisdiction of the Commission, *some separation of the property, capital, and revenue is essential in order that regulation may be confined to its permitted field.* The separation may be appropriately effected by estimating or appraising the value of the property used in the regulated business and that used in the unregulated business. Smith v. Illinois Bell Telephone Co., 282 U. S. 133. But that method in its completeness is not always exclusive of others. The separation or allocation may be effected by application of any formula which makes the principle a working one suitably adapted to the particular circumstances. Columbus Gas & Fuel Co. v. Public Utilities Commission, supra. (Italics supplied.)

In that case, the Commission had made an allocation, although it was not in accordance with that contended for

by the Companies. In the case at bar, however, the Commission declined to make any allocation whatever, notwithstanding the evidence introduced by petitioners and by its own staff. (R. 3994-4002 and R. 5943-5955).

The question should be settled not only because of the conflict between the court below and the Tenth Circuit but also because a final determination by this Court is essential in order properly to delimit the authority of the Commission under the Act.

4. *The decision of the court below is in conflict with principles established by this Court and with specific statutory provisions of the Natural Gas Act.*

(a) The holding of the court below that it was not error for the Commission's trial examiner to exclude evidence of reproduction or replacement cost of petitioners' physical properties and the market value of their leaseholds is in conflict with decisions of this Court.[8]

It is petitioners' contention that evidence of the price at which the physical facilities can now be reproduced and the price at which certain of its properties can now be sold is relevant and material in determining the just and reasonable return which the regulated company is entitled to receive. Petitioners in the case at bar insisted that the Commission, exercising its discretion, could and should take into account the increased value which the proffered evidence would show exists in petitioners' physical properties and in the present value of the gas leaseholds when determining the return allowed, irrespective of the con-

[8] Morgan v. U. S. 298 U. S. 468; Ohio Bell Telephone Company v. Public Utilities Comm., 301 U. S. 292; Los Angeles Gas & Electric Corporation v. R. R. Commission, 289 U. S. 287; Driscoll v. Edison Light & Power Co., 307 U. S. 104; Bluefield Waterworks and Improvement Co. v. Public Service Commission, 262 U. S. 679.

sideration, if any, given such evidence in fixing the rate base. Petitioners' excluded evidence unquestionably constitutes "facts and circumstances which ought to be considered." *Morgan* v. *U. S.* 298 U. S. 468, 480. Petitioners fail to see how anyone can deny the practical value and importance of such evidence to the Commission in determining what formula or combination of formulas it would use in making its pragmatic adjustments and to the reviewing Court in appraising the "end result" of the Commission's action "viewed in its entirety."

As pointed out, the Commission is not bound by the statute to reduce the regulated company's revenues to the lowest possible rates which would serve the constitutional test of confiscation. The rates are to be just and reasonable. (Sec. 5 (a) of the Act; 15 U.S.C. 717 (d).) Under this statutory standard there is a "zone of reasonableness" within which a rate higher than that which would be barely non-confiscatory could be allowed. Evidence of present value furnishes an excellent guide for determining, within this zone of reasonableness, the just and reasonable rate if the Commission finds that strict adherence to the formula of depreciated original cost produces an "end result" which is not confiscatory but is unreasonable and discriminatory from the standpoint of the stockholders of the regulated company. There is, clearly, nothing in the opinions in the *Hope* case and in the *Natural Gas Pipe Line* case which would lend support to the Commission's action. There are expressions in those cases which would indicate that the action of the Commission is in conflict with those decisions.

(b) Section 1(b) of the Act expressly provides that the provisions of the Act shall not apply to the production or gathering of natural gas. It is petitioners' contention that

it was the statutory duty of the Commission to segregate petitioners' production and gathering properties and the revenues and expenses related thereto. An alternative approach, which seems to lead to the same result was the contention that, while the operations might all be included within the petitioners' rate accounting structure, the rate base valuations of leases and other assets relating solely to production and gathering must be consistent with their status as unregulated properties. The Commission, however, not only failed to segregate the production and gathering phase of petitioners' business but it actually included in the rate base all of petitioners' production and gathering facilities and gas leaseholds at their original cost depreciated, depleted and amortized. These leaseholds were carried on petitioners' books at only $955,096, although petitioners were prepared to show, and offered to prove, that these leaseholds had a market value on June 1, 1941, of nearly $8,500,000 (Ex. 39, R. 4199, 4201, 492). Thus, in total disregard of the Congressional mandate, the Commission arrogated unto itself jurisdiction over an unregulated portion of petitioners' property and business as fully and completely as it exercised jurisdiction over petitioners' transportation facilities and business, which latter facilities and resale business are within the ambit of the Commission's statutory authority.

The order of the Commission is peculiarly subject to attack in these proceedings because, as noted, the Commission excluded evidence which was admissible in reaching a determination with respect to the value of the commodity in the fields where produced. The decision of the court below in affirming the action of the Commission is in conflict with applicable decisions of this Court.[9]

[9] Cases cited in footnote 8, supra.

While the Natural Gas Act excludes the production and gathering of gas from the Commission's jurisdiction and permits it to exercise jurisdiction only over the interstate transportation of gas and over certain (not all) sales thereof in interstate commerce, the Commission has by its order herein found that petitioners are entitled to a price in the field for their gas, predicated solely on a consideration of the original cost of their leaseholds less accruals for depletion and the application thereto of a 6½% rate of return. This it has done notwithstanding the fact that production and gathering of gas are expressly excluded from the application of the provisions of the Natural Gas Act.

It is obvious that, if petitioners' leaseholds can now be sold for more than $8,000,000, an allowance of an earning on only a value of less than $1,000,000 is wholly erroneous and arbitrary. It is to be assumed that the market value of the leaseholds is largely reflected in the market price, or the value of the gas in the respective areas where it is produced. Such market price or field value is determined by many economic conditions and field transactions having no relation to the original cost of the leaseholds.

The Commission in reaching into and regulating this phase of the petitioners' business clearly went beyond the scope of its authority.

(c) The holding of the court below that the Commission did not commit error in refusing to make an allocation between the regulated and the unregulated portions of petitioners' business is in conflict with applicable decisions of this Court.[10]

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[10] Smith v. Illinois Bell Telephone Co., 282 U. S. 133, 150; Minnesota Rate Cases (Simpson v. Shepard) 230 U. S. 352, 435, 437; Banton v. Belt Line Ry. Corp. 268 U. S. 413, 421; Northern Pacific Railway Co. v. McCue, 236 U. S. 585, 596-597.

Section 1(b) of the Act expressly excludes from its application, and consequently from the jurisdiction of the Commission, any sale of natural gas which is not a "sale in interstate commerce of natural gas *for resale* for ultimate public consumption for domestic, commercial, industrial or any other use." (Italics supplied.)

The Commission recognized its lack of jurisdiction over direct sales in proceedings before it involving other "natural-gas companies" and in such proceedings made the necessary allocations.[11]

It refused, however, in the case at bar to allocate and set apart that portion of petitioners' gross revenue attributable to their direct sales for customers' own use and their expenses incident thereto, although both the Commission's staff and the petitioners presented for the Commission's consideration detailed exhibits and supporting testimony to serve as a basis for an allocation (Ex. 263, R. 6883-6887, R. 3994-4002; Ex. 251, R. 5949-5955, 3631-3676, 3919-3933).

The Commission, in refusing to make such an allocation, committed a fundamental error which renders its order void and unenforceable.

(d) The decision of the court below, affirming the order of the Commission reducing petitioners' rates is erroneous in that under the tests and standards established by this Court the return allowed petitioners is inadequate.

In petitioners' case the Commission construed the Natural Gas Act as prescribing the use of a single formula. This construction permeates its entire opinion and accounts for the results reached. The Commission construed the Act as limiting petitioners' return to the allowance of

[11] Re Interstate Natural Gas Company, Inc., 48 PUR (NS) 267, 279; Re Canadian River Gas Co., Inc., 43 PUR (NS) 205, 231; Re Cities Service Gas Co., 50 PUR (NS) 65, 89.

what it determines to be a "fair and reasonable" return upon the actual legitimate cost of petitioners' property devoted to public service, less existing depreciation, plus a reasonable allowance for working capital "and no more" (R. 29).

The opinion of this Court in the *Hope* case shows that such a construction is erroneous. That opinion supports the contention made by petitioners throughout this case that, when rates are tested to determine whether the return allowed is confiscatory, it is necessary to ascertain whether the revenues available from the rates allowed will be adequate to pay all operating charges of the company and such service charges on its invested capital, including debt capital, preferred stock, common stock and surplus, as will be required by investors to compensate them for the risks assumed and to induce them to continue to invest in the company's securities. This contention of petitioners was characterized by the Commission as a "novel theory" (R. 29). Nevertheless, it is exactly the theory adopted by this Court in the *Hope* case in reaching a determination that the dollars allowed Hope as a return were adequate for the needs of that particular company.

The opinion in the *Hope* case clearly shows that the Act provides no formula for determining either rate base or rate of return; that the Commission's duty is to fix a just and reasonable price for the commodity, the gas sold in interstate commerce for resale; that, in fixing such a price, the Commission is not limited to any formula; that, in determining whether the end point, i.e., the price fixed, is non-confiscatory, the Court will consider, among other things, whether the return allowed a particular company will enable it to pay its operating expenses and service charges on its capital structure and will be adequate to maintain the credit of that particular company and to

attract capital to its securities. It was for this reason that this Court discussed in some detail the corporate structure, ownership, affiliation and earnings of Hope. These were the elements which were used in testing the constitutional and statutory adequacy of the return allowed. After making such a test, the Court reached the conclusion that the Company had failed to show that the return allowed, $2,191,314, was inadequate, from the "investor or company viewpoint."

Petitioners' evidence showed that they required a return of $5,172,129 as the necessary cost of servicing their capital structure. The Commission allowed only $4,363,925 as a return. The Commission found the cost of servicing the long term debt and preferred stock, but made no finding as to the cost of servicing the common stock and surplus, and failed in the order to make adequate provision for a return sufficient to service the entire structure.

There are many points at which the facts in the *Hope* case and the case at bar differ and yet, in considering the adequacy of the return allowed petitioners, the Commission and the court below ignored many facts of importance in this case which are comparable to facts considered important by this Court in the *Hope* case.

Panhandle Eastern is not an old and seasoned enterprise. It has not had four decades of highly profitable operations. It has not earned, as did Hope, its original investment several times, plus a surplus available for dividends in poor years far in excess of its original capitalization. Panhandle Eastern during its life of nine and three-quarters years had not earned the amount of its original capital, whereas Hope had earned its original investment more than eight times over. It is, therefore, obvious that Hope's financial position and history, which this Court viewed as significant when considering the propriety of

the Commission's action, are entirely different from petitioners' in many material respects.

Hope's capital structure was composed of only common stock and surplus, whereas petitioners' capital structure is composed of long-term debt ($33,254,500), preferred stock ($16,000,000) and common stock and surplus ($27,294,990). It is also apparent that there is considerable difference in the corporate ownership of petitioners and of Hope. Hope was a wholly owned subsidiary of Standard Oil Company (N. J.). The corporate stability and advantages for readily obtaining financing resulting from such an affiliation are obvious. Panhandle Eastern, on the other hand, has been required to rely wholly on its own resources when seeking needed capital. This Court considered it of importance that Hope's principal market outlets were affiliated distributing companies, whereas petitioners have no such protection.

The Commission included in Hope's rate base $1,392,021 as future capital additions for 1941, 1942, and 1943. It refused to include in petitioners' rate base capital additions to transmission plant in the course of actual construction at the close of the hearing, although petitioners then had in their treasury the funds to pay for such construction and although a substantial part of such construction (approximately $5,000,000) would not increase the daily sales capacity of the transmission system (R. 1951-1954).

The Commission allowed Hope an annual operating expense of $600,000 as future field exploration and development costs but refused to include in petitioners' rate base the capital expenditures required in the gas fields to maintain their present load. Of these capital expenditures $2,811,902 was required during the years 1941 and 1942 (R. 4244). The Commission's allowance for working capi-

tal was inadequate. It allowed nothing for line pack (R. 26). It allowed only $489,893 for material and supplies and only $101,097 for prepayments (R. 25). The amounts of these items on March 31, 1942, as shown by petitioners' books were $541,129 and $197,199, respectively (Ex. 267, R. 6993). The Commission refused petitioners any of their rate case expense in the amount of $350,000 (R. 31, 33) and refused to include in estimated operating expenses their increased payroll costs and increased expense of employees' welfare and pension plans amounting to $103,500 annually (R. 31).

It is apparent that facts which this Court considered sufficient to sustain the Commission's order in the *Hope* case do not exist as support for the Commission's order in petitioners' case. The adequacy of the return allowed must be determined from a consideration of petiitoners' requirements arising out of their particular situation. This the Commission failed to do, and the end result is inadequate, unjust and unreasonable to petitioners.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be granted.

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APPENDIX

The pertinent provisions of the Natural Gas Act of 1938, 52 Stat. 821, et seq. (15 U. S. C. Sec. 717) are as follows:

SEC. 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

(b) The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

* * * * *

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge,

classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

* * * * *

SEC. 6. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

* * * * *

SEC. 19. (b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be served upon any member of the Commission and thereupon the Commission shall certify and file with the court a transcript of the record upon which the order complained of was entered. Upon the filing of such transcript such court shall have exclusive jurisdiction to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall

have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).